

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Ed Hutzmann
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from: Janine Cook
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Tax/Government Entities)
(Tax Exempt & Government Entities)

subject: Interest-free Adjustments and Penalties

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the subject of an employment tax examination is entitled to an interest-free adjustment under section 6205 when the accuracy-related penalty under section 6662(b)(1) applies.

CONCLUSION

The determination of whether the subject of an employment tax examination is entitled to an interest-free adjustment is based on whether the taxpayer meets the requirements for an interest-free adjustment under section 6205 and the regulations thereunder. However, the facts and circumstances warranting application of the accuracy-related penalty may indicate that the underpayment was not the result of an error or that the taxpayer knowingly underreported its liability, therefore precluding the taxpayer from receiving an interest-free adjustment under section 6205.

FACTS

You have requested advice with regard to an issue that Examiners have encountered in employment tax examinations. In such examinations Examiners must determine whether application of the accuracy-related penalty to an employment tax underpayment precludes the taxpayer from receiving an interest-free adjustment for the amount of the underpayment.

This memorandum does not address situations where penalties other than the accuracy-related penalty are warranted.

LAW AND ANALYSIS

Section 6662(a) provides for a penalty equal to 20% of the portion of an underpayment to which the section applies. Section 6662(b)(1) provides in relevant part that section 6662(a) applies to the portion of the underpayment which is attributable to negligence or disregard of rules or regulations.

Section 6662(c) provides that for purposes of section 6662, the term “negligence” includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term “disregard” includes any careless, reckless, or intentional disregard.

The accuracy-related penalty imposed under section 6662(b)(1) for negligence or disregard of rules or regulations applies to various types of culpable behavior. Section 1.6662-3(b)(1) of the Income Tax Regulations provides that the term “negligence” includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return and includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Section 1.6662-3(b)(2) provides that the term “disregard” includes any careless, reckless, or intentional disregard of rules or regulations. A disregard is “careless” if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position. Id. A disregard is “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulations exists, under circumstances that demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. Id. A disregard is “intentional” if the taxpayer knows of the rule or regulation that is disregarded. Id.

The common link between the different forms of conduct sanctioned by the section 6662(b)(1) penalty is culpability. A finding of negligence, intentional disregard of the regulations, recklessness or carelessness implies some level of bad intention by the taxpayer.

Section 6205(a)(1) provides that if less than the correct amount of tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of wages or compensation, proper adjustments, with respect to both the tax and the amount to be

deducted, shall be made, without interest, in such manner and at such times as the Secretary may by regulations prescribe.

Section 31.6205-1(a)(1)¹ of the Employment Tax Regulations provides that an employer who makes, or has made, an undercollection or underpayment of employee tax under section 3101, employer tax under section 3111, employee tax under section 3201, employer tax under section 3221, or income tax required under section 3402 to be withheld, with respect to any payment of wages or compensation, shall correct such error as provided in this section and that such correction shall constitute an interest-free adjustment to the extent provided in (b) or (c) of this section.

Section 31.6205-1(a)(4) provides that an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Section 31.6205-1(a)(6) provides that an interest-free adjustment may not be made after the earlier of receipt of notice and demand for payment based on an assessment or receipt of a Notice of Determination of Worker Classification under section 7436.

Section 31.6205-1(b)(2) provides in relevant part that if a return is filed, and if no employee tax, no employer tax or less than the correct amount of either such tax with respect to any payment to an employee of wages as defined in the Federal Insurance Contributions Act, or compensation as defined in the Railroad Retirement Tax Act, is reported on such return and paid to the Service, the employer shall correct the underpayment by making an interest-free adjustment.

Section 31.6205-1(c)(2) provides in relevant part that if a return is filed for a return period, and if no income tax, or less than the correct amount of income tax, required under section 3402 to be withheld from wages paid to an employee in such period, is reported on a return and paid to the Service, the employer shall correct the underpayment by making an interest-free adjustment.

Revenue Ruling 75-464, 1975-2 CB 474, addresses interest-free adjustments in the context of an audit. The ruling provides that since an error may not be discovered until an audit is made of the employer's tax returns by the Internal Revenue Service, if a Form 2504, Agreement to Assessment and Collection of Additional Tax, is signed at the conclusion of such audit, the agreement form will be considered to satisfy the interest-free adjustment requirements under section 31.6205-1(b) and/or (c).² The ruling goes

¹ Treasury Decision 9405 (REG-111583-07) was published in the Federal Register on July 1, 2008 (73 FR 37371) amending the regulations under section 6205 and modifying the process by which interest-free adjustments to employment taxes are made. TD 9405 is effective January 1, 2009 and applies to errors ascertained on or after January 1, 2009. The regulations did not change the adjustment process in any substantial way relevant to this memorandum, other than clarifying the limitations on its use. See note 2, *supra*.

² T.D. 9405 incorporated this aspect of Rev. Rul. 75-464 into the final regulations under section 6205, effective January 1, 2009, confirming the application of interest-free adjustments in the examination context. See *supra*, note 1. Specifically, section 31.6205-1(a)(7) provides that forms used in examination to agree to the adjustment may constitute adjusted returns and receive interest-free treatment.

on to provide that the Service will not allow interest-free adjustments in cases in which the taxpayer's returns for prior years were audited and additional tax found to be due with respect of the same issue involved in the current audit, nor in cases in which the taxpayer, after having been informed of his tax status as an employer, knowingly underreports his employment tax liability in subsequent years.³

Neither the interest-free adjustment rules under section 6205 nor the accompanying regulations define the term "error" for purposes of determining when an interest-free adjustment may be made. The Merriam-Webster dictionary defines "error" as an act or condition of ignorant or imprudent deviation from a code of behavior, an act involving an unintentional deviation from truth or accuracy, or an act that through ignorance, deficiency, or accident departs from or fails to achieve what should be done. There is no statutory or regulatory provision linking the meaning of an "error" for purposes of section 6205 with the standard for imposing the accuracy-related penalty under section 6662(b)(1). As a practical matter, the same facts that indicate that the penalty is warranted may also indicate that there was no error for purposes of section 6205 or that the employer knowingly underreported its liability so that no interest-free adjustment is available. However, an interest-free adjustment should not be denied solely because the accuracy-related penalty is imposed. Rather, the Examiner should examine the facts to determine if the employer is entitled to an interest-free adjustment under the applicable guidance.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

TIGTA Report Reference Number 2003-30-042 (TIGTA Report) has been cited as support for the position that where an interest-free adjustment applies the Service should restrict the automatic assessment of penalties. However, the TIGTA Report specifically addressed the inconsistency of automatically asserting penalties (specifically penalties for failure to file, pay, and deposit) on late-filed employment returns due to worker misclassification where interest was waived. The Report was concerned with the fact that employers who had misclassified workers and had made corrections pursuant to section 6205 and the regulations by filing late original returns were being automatically assessed penalties. The Report recommended that in the context of worker misclassification where interest was waived on late-filed returns, the failure to file, pay, and deposit penalties should also be waived. We do not read the Report to imply that all penalties should be waived in all cases where section 6205 applies.

³ T.D. 9405 also incorporated the limitation regarding underpayments that cannot be adjusted on an interest-free basis. Specifically, section 31.6205-1(a)(2) clarifies that no correction of an underpayment will be eligible for interest-free adjustment treatment if the failure to report relates to an issue that was raised in an examination of a prior return period or if the employer knowingly underreported its employment tax liability.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-0047 if you have any further questions.

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